

DEFINED BENEFIT PLANS

Only qualified retirement plan to provide employees with a **guaranteed retirement benefit** payable at normal retirement age, with reduced benefits payable at an earlier retirement date.

Benefit is usually a monthly benefit based on compensation and years of service, and **payable for the lifetime of the participant.**

Plans may allow for "**cash out**" at retirement, with participant receiving a single lump sum instead of monthly payments.

Employer has obligation to make necessary contributions. Premiums may be paid to the Pension Benefit Guaranty Corporation to insure the benefits.

A **412(i) plan** is a defined benefit retirement plan whose funding requirements fall under Internal Revenue Code Section 412(i). If a plan meets the requirements of this subsection, it is **exempt from the complex funding rules** of Section 412 of the IRC applicable to all other defined benefit plans.

Since the passage of the Tax Reform Act of 1986 and the Omnibus Budget Reconciliation Act of 1987, the small business owner has lost interest in defined benefit plans.

A "fully insured" 412(i) plans provides an attractive alternative solution offering **simplicity, maximum current tax-deductible contributions and guaranteed retirement benefits.**

FEATURES

A "Defined Benefit 412(i) plan" is a special type of defined benefit pension plan, with three significant characteristics:

- Fully Guaranteed Retirement Benefit

- Must be funded with Insurance Contracts

- Typically generates largest possible tax deduction

Defined Benefit 412(i) Plans allow deductible contributions in excess of 25% of compensation.

412(i) Plans are ideally suited for the small business employer (6 or less employees) who was unable to save in the early years and now, with stable future business profits, desires to put away a very large, tax deductible contribution.

In addition to providing funding for future retirement income, tax deductible 412(i) contributions reduce current taxable income and increases tax deductions.

Self employed individuals, with expectations of stable future income, may find the features

of the 412(i) attractive.

Business owners, starting a second career, should give consideration to the creation of a 412i Defined Benefit Plan.

Additional protection for family and heirs may be provided with the addition of an insured death benefit to the plan. This also further reduces taxable income and increases tax deductions.

REQUIREMENTS

In order for a plan to qualify under Section 412(i), certain requirements must be met:

- The plan must be funded solely with individual or group life insurance and annuity contracts that are part of the same series and use same mortality tables and rate assumptions for all participants.
- Insurance contracts must fund benefits using level premiums for all benefits. Payments begin when a participant enters the plan and may extend no later than the retirement date specified under the plan.
- Plan benefits must be provided only by these contracts and be guaranteed by an insurance company. In effect, the plan is "fully insured."
- Participants may not take loans.

These requirements are easily satisfied using IRS-approved prototype plans, funded by products designed specifically for this marketplace. The Pension Professionals can provide products that are ideally suited for use under a 412(i) plan, together with prototype defined plan and trust allowing the plan to meet "fully insured" requirements.

ADVANTAGES

A "fully insured" plan can provide substantial retirement benefits under this simple and secure program. The accrued benefit for participants is simply the cash surrender value of all insurance contracts. It provides a maximum current tax deductible contribution for the business. Some of its other advantages include:

- No full-funding limitation under ERISA Section 404(a)(1)(A) or current liability test to limit contributions.
- There can be no over-funding.
- There can be no under-funding. Contributions are based solely on the guaranteed provision of the level premium contracts.

- No actuarial certification required.
- Substantial administrative savings through the use of an IRS-approved prototype. Wealth Preservation Strategies can advise on special programs available for very reasonable administrative fees.
- No quarterly contributions are required, unlike a traditional defined benefit plan; the "fully insured" model may be funded annually without having to pay interest.
- The IRS will not challenge the plan assumptions, thus permitting higher deductions. It is the contract guarantees that govern the required contributions.

DISADVANTAGES

The 412(i) plan may not be the ideal plan for all situations and businesses. Given the large, required contributions that must be made each year, it works only when the business is established and highly profitable. It works best when there are very few employees (less than five); and where the owner is fifty years old or within 10 years of retirement and is older than any of the firm's employees. In brief, its disadvantages include:

- No policy loans can be outstanding at year end. This is not normally an issue, as many owners of a small business cannot normally participate in any retirement plan loan program.
- No flexibility in investments. The plan must be funded exclusively through insurance contracts in order for all benefits to be guaranteed.

HOW 412(i) WORKS

When compared with other types of defined benefit plans, larger current contributions are created with a 412(i) plan. Life insurance and annuity guaranteed assumptions are conservative. A Traditional Defined Benefit Plan will have an interest rate assumption much

higher than the guaranteed interest rate in a "fully insured" plan. The lower the plan assumptions, the higher the required contribution. It's that simple.

INVESTMENTS & GAINS

It can be expected that some insurance contracts may earn interest above the guaranteed rate. Dividends may be paid on "participating" life insurance contracts. Both dividends and interest in excess of the guaranteed rate will decrease the employer's contribution in a following year. It should be noted that life insurance dividends for all defined benefit plans must be used to reduce the premium.

Such gains will tend to increase over time, essentially lowering the cost of the 412(i) plan. Hence, if all else remains unchanged, the "fully insured" plan's tax-deductible contributions will be greater in the early years. In contrast, due to limitations imposed by the Omnibus Budget Reconciliation Act of 1987 (OBRA), the funding costs for traditional defined benefit plans will often tend to increase over time.

Contributions for traditional defined benefit plans fluctuate due to actuarial and investment experience. To ensure minimum funding standards are met, an enrolled actuary is required to certify the plan each year. Investment rates are not known and can vary greatly over time. It is this type of variability that can cause a traditional defined benefit plan to become over-funded (a higher investment return than expected) or under-funded (not enough contributions, given the actual investment return and benefits paid.)

A 412(i) plan needs no actuarial certification, as only enough money to provide the guaranteed benefits can be paid to the plan. There can be no over-funding or under-funding problems. This is simple, too.

BENEFITS

A "fully insured" plan is subject to the same maximum benefit limitations and "top heavy" provisions as a traditional defined benefit plan. Let's examine each of these in greater detail.

TOP HEAVY RULES

Top heavy rules are simplified:

1. 5-year lookback to determine key employees modified to a 1-year testing period (data for 4 preceding years ignored);
2. Compensation used to determine officers is increased to \$130,000 (subject to cost of living adjustments, in \$5,000 multiples, starting in 2003);
3. Top 10 employee test eliminated.
4. Matching contributions will now count toward satisfying the top heavy minimum contribution requirement and are still counted in the ACP test;
5. 1-year look back instead of 5-year look back applies for adding prior distributions made after termination of service or plan termination;
6. Safe harbor 401(k) and 401(m) plans are exempt from the top heavy rules;
7. Top heavy minimum accruals are not required under a frozen defined benefit plan.

The Pension Professionals provides solutions to this problem through plan design, selecting benefit formulas that are much higher than the minimum top heavy requirements.

MAXIMUM BENEFIT LIMITATION

The ERISA section that limits the overall plan benefit is known as the "415 limit." Section 415 applies to all defined benefit plans in the same way. It dictates the maximum retirement benefit. Currently, this provision limits a defined benefit plan to a maximum of \$160,000 of annual income. This amount is reduced if the actual retirement age is less than Social Security retirement age.

A common technique used to increase the ultimate retirement benefit beyond the Section 415 limit is to roll the lump sum value of the retirement benefit into an Individual Retirement Account (IRA). Before this can be done, however, the lump sum benefit to be rolled out of the plan would need to comply with the Section 415 benefit accrual limit and the provisions of the Retirement Protection Act of 1994 (RPA '94), a provision within the General Agreement on Tariffs and Trade (GATT) treaty.

RPA '94 specifies that the maximum lump sum distribution must be calculated using the GATT-provided mortality table and an indexed interest rate that may be set higher than the 412(i) guaranteed interest rate. These provisions may reduce the amount that may be taken in the form of a lump sum distribution when compared to pre-GATT provisions. It should be noted that this will only affect benefits that are taken in the form of a lump sum and only as they approach the Section 415 maximum dollar limit.

The Pension Professionals sometimes suggests minimizing this lump-sum distribution problem by using a plan designed to initially be below the Section 415 limit, with the expectation that the lump sum will be rolled out of the plan into an IRA. Even with this reduced limit, the "fully insured" plan provides a much larger current deduction when compared to a traditional defined benefit plan.

LIFE INSURANCE

To maximize the available benefits of a 412(i) plan, an option to purchase life insurance under the plan may provide up to one half of the plan retirement benefits. The guaranteed cash values and guaranteed premiums of The Pension Professionals suggested whole life insurance contracts are ideal for funding such a "fully insured" plan.

Life insurance in all qualified retirement plans must comply with the "incidental insurance" rules discussed in Treasury Reg. Section 1.401 (b)(1)(i). These provisions place a limit on the amount of life insurance that may be purchased under the plan. Generally, a defined benefit plan can provide no more than 100 times the projected monthly retirement income as a pre-retirement survivor benefit. An alternative provision under Rev. Rul. 74-307 instead allows up to one half of the level premium to be used to purchase life insurance contracts within a defined benefit plan.

While life insurance does not need to be offered under a 412(i) plan, this feature does provide important additional benefits for a participant. If there is an insurance need, the participants may obtain the benefits of life insurance on a pre-tax basis. For highly profitable, closely held businesses, there often exists a substantial insurance need for the owner. A "fully insured" plan cannot only maximize the current deductions, but can also meet these needs by funding the benefit with life insurance contracts.

TAXABLE "ECONOMIC BENEFIT"

When life insurance is included inside a pension plan, the participants must recognize as a taxable cost the "current economic benefit" provided by the plan (IRC Section 72(m)3(B), Reg. Section 1.72-16(b)). Each participant is then taxed currently on the cost of the "pure" life insurance benefit. The cost of this current benefit is known as the P.S.58 cost. The cost is determined by using the one-year term rates published in Rev. Rul. 55-747. if, however, the insurance company's one-year term rates are lower, the participant may use the insurer's lower rate to determine the amount to be included in gross income (Rev. Rul.66-110, 1966-1 CB 12).

The Pension Professionals can provide policies with very competitive one-year term rates. For example, the initial year's taxable income for a \$1,000,000 face amount for a 50-year-old is:

Using the Government's P.S.58 Rates \$9,220

Using WPS suggested Taxable Term Rates \$1,020

OVERCOMING THE \$40,000 LIMIT

Defined Contribution plans, especially 401(k) plans, have enjoyed tremendous popularity over the past 10 years. Now some employers are shifting toward defined benefit pension plans that deliver guaranteed benefits and large tax deductions.

Successful small business owners and professionals are expressing renewed interest in insured fully guaranteed defined benefit plans to assure enough money is set aside at retirement.

Recent pension legislation now encourages this rebirth, permitting much higher tax deductions than defined contribution or 401 (k) plans. And, in the year 2002, employers will no longer be restricted in what they can contribute to a Defined Benefit Plan due to participation in a prior Defined Contribution Plan.

Age-based plans like Age Weighted or Select pension or profit sharing plans work well in shifting the majority of the plan contribution in favor of the older business owner. But the problem with these plans is that they are capped at the \$40,000 contribution limit.

The Solution: Fully Insured Defined Benefit Plans

As you can see from the figures on the reverse side, plan deductions can be significantly higher than any other plan type. It is possible to generate deductions well over \$100,000 annually. Maximum insurance amounts can reach up to \$3,000,000!

Add to this the other advantages of a fully insured plan:

- Easy to explain - plan provides a specified retirement benefit which is fully guaranteed.*
- Easy to understand "accrued benefits" equal to the cash value of the life insurance and annuity contracts.

*Guarantees are dependent upon the claims paying ability of the issuer.

MAXIMUM DEDUCTIONS & MAXIMUM INSURANCE

Retirement Age: 65
Amount of Tax Deduction

Age	Annual Pension	412(i) No Insurance	412(i) Maximum Insurance	Face Amount of Insurance	Cash at Retirement*
60	\$73,500	\$216,439	\$279,687	\$3,365,889	\$1,065,217
55	160,000	218,197	248,703	4,189,409	2,318,782
50	160,000	134,491	149,199	3,110,475	2,318,782
45	160,000	93,091	101,537	2,538,561	2,318,782

Retirement Age: 60
Amount of Tax Deduction

Age	Annual Pension	412(i) No Insurance	412(i) Maximum Insurance	Face Amount of Insurance	Cash at Retirement*
55	\$63,516	\$210,876	\$265,581	\$4,083,999	\$1,037,843
50	138,660	213,201	236,278	4,991,041	2,265,686
45	138,660	131,411	142,353	3,638,584	2,265,686

Retirement Age: 55
Amount of Tax Deduction

Age	Annual Pension	412(i) No Insurance	412(i) Maximum Insurance	Face Amount of Insurance	Cash at Retirement*
50	\$44,856	\$164,397	\$202,776	\$3,893,753	\$ 809,091
45	98,700	167,526	182,025	4,709,560	1,780,303

*Lump sum payments under defined benefit plans after 1994 are limited by the provisions of the GATT bill.

This illustration limits benefits to show lump sum payments which might become payable. These figures are based on NL Advantage Gold whole life insurance (Policy #6597), UNISEX, non-smoker rates and Life of the Southwest Equity Indexed Annuity (Policy #7691) annuity contracts. Insurance contracts are underwritten by National Life Insurance Company, Montpelier, Vermont. These products may not be available in all states.

CONCLUSION

A 412(i) plan is simple and may perhaps be the ideal plan for the owner of a small business or professional enterprise who desires to maximize his or her current tax deduction and secure guaranteed retirement income. The contributions are, by design, quite large in the early years of the plan and may be less appealing as the number of plan participants increases. Introducing life insurance to fund a portion of the benefit will provide increased initial contributions and a current pre-tax life insurance benefit for each participant.

Questions and Answers

Q. What is a 412(i) plan?

A. It is a defined benefit pension plan whose annual contribution is calculated under the rules of IRS Code Section 412(i). It is also referred to as a “Fully Insured Plan,” or an “Insurance Contract Plan.” The plan is funded exclusively with insurance products.

Q. Why would a business owner adopt a 412(i) defined benefit plan?

A. Adopting a 412(i) plan is an important financial tool for retirement planning. It provides an opportunity to achieve retirement goals without stock market risk to the principal.

Q. Who can adopt a 412(i) plan?

A. All business entities are eligible for a 412(i) plan. This includes sole proprietors, partnerships, C corporations, S corporations, and Limited Liability Companies. The business entity must have stable income, as fluctuating income can create potential funding problems.

Q. Who is included in a 412(i) plan?

A. The eligibility requirements generally are: employees must be 21 years old, and have one year of service that included 1,000 hours. Once employees have met the eligibility requirements, they are included in the plan.

Q. How do I know when an employee is an eligible participant and how much to contribute?

A. A retirement plan service provider helps track the employees and the required contributions.

Q. Do 412(i) plans have a vesting schedule?

A. Yes. One of the advantages of a qualified retirement plan is the vesting schedule. Most plans use a vesting schedule that requires employees to work for an employer a specified period, such as six years, before they are 100 percent vested. If a participant's employment is terminated before they are vested, the nonvested portion of their account is forfeited and remains in the plan.

Q. How do I fund a 412(i) plan?

A. The plan is funded exclusively with annuity and life insurance, or annuity only. The benefits are guaranteed by the contracts provided the annual premiums have been paid.

Q. What are the advantages of life insurance in a 412(i) plan?

A. The advantages are:

- Tax-deductible premium
- Pre-retirement death benefit
- Income tax advantage at death

Q. Can I skip funding a year if my business is down?

A. No. A 412(i) plan is a pension plan that requires annual funding.

Q. Once I adopt the plan, can the contribution formula be changed?

A. If your business or cash flow increases or decreases, you may want to change the contribution level. There are specific time periods when the plan can be amended. If contribution flexibility is a requirement, you may want to consider a profit sharing plan.

Q. If the owner's compensation greatly decreases, how will this impact the contribution level?

A. Since contributions are calculated based upon an average of compensation for each participant for no less than three years and usually for five years, a decrease in compensation has a varied effect. Let's look at two examples where the benefit is based upon the five highest consecutive years of compensation while a participant.

If an owner-participant has compensation of \$200,000 for years one through four and \$50,000 in year five, a slight decrease in funding would result in year five compared to the prior year. The reason for the slight decrease is because the average of five years of compensation used to calculate the contribution is only lowered to \$170,000 compared to the prior year's average of \$200,000.

In our second example, the owner-participant has compensation of \$200,000 in year one and \$50,000 in year two (since a five year average is required, the \$50,000 is projected to be earned for the additional three years as well). This would result in an average salary of \$80,000 as opposed to the prior year's average of \$200,000, and hence, a rather large decrease in contribution required.

Q. Can a participant in a 412(i) plan borrow under the plan?

A. No loans are allowed under 412(i) rules.

Q. Why is a 412(i) plan less appealing to a large firm?

A. By design, a 412(i) plan is expensive. The concept is less attractive as the number of plan participants increases.

Q. Can I adopt a 412(i) plan if I have a retirement plan?

A. Your options for the current year depend on various factors, such as the type of plan and the contributions made for the current year.

Q. How do I start a 412(i) plan?

A. The steps are:

1. Review the retirement plan proposal presented by Level Four Insurance Services
2. Adopt the plan by signing the Adoption Agreement
3. Fund the plan

Proposal Request Form

The data below will provide the information necessary to generate a plan proposal. Please complete all information.

Employer Name _____

Employer Address _____

Business Entity C-Corp. (W2) S-Corp. (W2) Partnership (K-1) Sole Proprietor (net Schedule C)
 LLP LLC (indicate LLC tax filing status Partnership or Corporation or Sole Proprietor)

Fiscal Year _____ Desired annual contribution \$ _____ Anticipated retirement age of owner _____

Does the employer now have or ever had a retirement plan? Yes No If yes _____
 (Including a SEP, SIMPLE or any other retirement plan)

Do the owners have ownership interests in other businesses? Yes No If yes _____

Is the employer a controlled group or affiliated service group? Yes No If yes _____

Does the employer use leased employees, union employees or independent contractors? If yes, indicate in census. Yes No

Name (mark U if union, L if leased, or IC if independent contractor) We will accept an attached census with like information	Date of Birth	Date of Hire	Annual Salary	Ownership % or Family Relationship to Owner	Job Title (complete for all requests)	Hours worked (if < 1,000 hours)

Representative to be contacted:
 Address _____

Phone _____ Fax _____ Email (required) _____

Date proposal needed _____

Proposal Request Form

Client Review Topics

Review the following questions with your client and submit along with the completed Proposal Request Form to Level Four Insurance Services Sales Department. With these tools, we can assist you and the client in the design of a retirement plan that will help meet the client's needs.

Answer Yes or No to the following questions:

Does the client...

- Need a long-term savings program to shelter income and save for retirement?
- Need a larger tax deduction?
- Own a profitable business (C or S corporation, partnership, sole proprietorship, LLC, LLP)?
- Have cash flow to fund a pension benefit with required annual contributions?
- Have cash flow to fund discretionary contributions?
- Want to maximize benefits for owners and key employees?
- Need life insurance to provide a pre-retirement death benefit with tax-deductible premiums?
- Have an existing retirement plan? If yes, provide details.
- If the client currently has a plan, does it meet the employer's retirement objectives?

Employer's Retirement Plan Objectives:

Additional Comments \ Information:
